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Economic Conditions
Governmental Finance
United States Securities

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General Business Conditions

THE first month of the new year has brought a seasonal upturn in some of the chief industries, but nothing in the way of vigorous general trade and industrial recovery is yet evident. The banking situation has shown but slight improvement, failures having totaled 240 up to the 22nd of the month, and the currency put into circulation at Christmas time has not returned to the banks in normal volume, affording disappointing evidence of continued hoarding. The volume of bank credit in use has declined without interruption, the drop being in part seasonal, but nevertheless significant as to the state of business.

Despite these evidences of depression and anxiety, however, the month has been one of progress in dealing with major problems. The program for the support of credit has been carried forward to the point of setting up the Reconstruction Finance Corporation; progress is evident in the very important matter of initiating and speeding governmental economies; and successful completion of the negotiations for a 10 per cent railway wage reduction seems imminent, while in business generally cost and price reductions have been notably extended.

To remedy the condition of business there are almost as many plans and proposals as there are people, but in any list of measures to promote recovery that might be drawn up it is certain that those mentioned would stand near the top; and in view of the attention centered upon them they may accordingly provide the keys to the public confidence which everyone desires to unlock. The German situation also has been helped by negotiation of the new Stillhaltung agreement, though unfortunately the reparations question is still deadlocked.

Public sentiment has recognized the progress made, and the better showing in security prices and particularly in the corporate bond market during the month has indicated a more confident attitude on the part of investors. The bond market is the heart of the business situation. Its great decline has registered the unwillingness of investors to use their funds either in new financing to promote revival, or in refinancing to prevent further recession. It has been an effect of the same "frozen confidence" that has caused currency hoarding and credit strain. It is clear that the chief obstruction to a more abundant flow of investment funds is on the side of the lenders. There is no lack of borrowers. For this reason a period of upturn or steadiness in bond prices is genuine ground for encouragement, even though its continuance must be included among the other uncertainties of these uncertain times.

The Reconstruction Finance Corporation

The enactment of the Reconstruction Finance Corporation Act on January 22 is recognition by the government of the interest of all the people in supporting the credit-granting institutions against panicky demands by their depositors, and in bridging over the refinancing difficulties of the railways, in which the country's savings are so largely invested, in order to prevent unnecessary foreclosures and losses.

In this Letter last November was included a description of the background of the banking difficulties, to which we refer readers who may be interested in a fuller exposition than our space now permits. The situation is that the great decline in the market prices of commodities and manufactured goods of all kinds, of securities, and of real estate, has left many banks and credit institutions with loans on their books which may be good, but which at present cannot be paid off and which do not conform to the legal requirements that would make them eligible for rediscount at the Federal Reserve Banks. In short, many solvent banks find themselves lacking in liquid assets which can be converted into cash without forced sale. This would not cause acute difficulty in normal times, when bankers can count upon merely normal demands for funds by their depositors; but when fear takes possession as it has in some localities, and depositors become collectors instead of lenders, the institutions affected by these panicky demands

must also become collectors. A contraction of credit sets in which forces the sale of bonds by the banks, and of their own assets by those who cannot obtain credit, both at sacrifice prices. These sales in turn depress values, depreciate the assets of other persons and other banks, and so the effects go around the circle.

The establishment of the Reconstruction Finance Corporation recognizes that this is a situation affecting far more than the interests of the credit institutions, and constituting in truth a national emergency which the people should face together out of their common resources. It is plain that under the driving force of fear deflation has gone beyond the point where it is a corrective for old difficulties, and has become the cause of fresh and greater ones which only a check to deflation can cure. The bank failure epidemic has been the most powerful single deflationary element, and therefore to support the banking situation at important points is to take the most direct means to avert distress, restore confidence, promote business revival, and relieve unemployment.

Operations of the Corporation

The object of the Reconstruction Finance Corporation is to revive industry by reviving credit; and the immediate aim is to increase the willingness and ability to lend of financial institutions generally. Where solvent banks possessing adequate security are unable, by reason of a temporarily non-liquid condition, to serve the credit requirements of their community, the Corporation will make loans to restore their liquidity.

It will be agreed that the main cause of the credit strain is the fears of bank depositors. The Corporation will provide for solvent banks a bulwark against demands that might force their suspension, and thus is calculated to convince depositors that their money is safe and to draw back into the banking system the hoarded currency which is obstructing the flow of credit and impairing the ability of the banks to assist and encourage business. Essentially, it will strike at fear by guiding credit to the point of need, and thus supporting the emergency situations which are the cause of fear. In the case of institutions facing heavy withdrawals of deposits, the Corporation will assist them to meet demands without unnecessary sacrifice of assets, in this manner acting to check the involuntary credit deflation which we have described.

The Corporation is authorized to lend to banks of all kinds, loan associations, credit corporations and insurance companies, and to aid in the temporary financing of railroads which are unable to obtain funds "upon reasonable terms through banking channels or the general public," the approval of the Interstate Commerce Commission being required. Loans may be made to banks closed or in process of liquidation, to a total amount of $200,000,000, and the Secretary of Agriculture is allotted $50,000,000 for loans to farmers for crop production purposes. Inclusion of the railways in the Act is recognition of the dominant position of rail securities among the assets of financial institutions, and of the difficulties that would be incurred in refinancing through public offering the $270,000,000 of railway bonds, notes and equipment trust issues maturing this year, in view of the prices at which rail bonds are now selling. The provision for loans to closed banks is to facilitate reorganization or distribution of their assets to their depositors, in order that these "frozen funds" may be released to trade uses.

Administration of the Corporation is in the hands of seven directors, and President Hoover has appointed General Charles G. Dawes president and Mr. Eugene Meyer, governor of the Federal Reserve Board, chairman. The appointments made place the Corporation's funds in the hands of men experienced in the administration of credit, and assure that they will be used at points of need where their effects will be as intended.

The initial funds of the Corporation will consist of $500,000,000 of capital subscribed by the Federal Treasury, and further funds not to exceed $1,500,000,000 may be raised through the sale of obligations as funds are needed. These obligations will be guaranteed both as to interest and principal by the United States and the Treasury is authorized to buy and sell them, but they will not be eligible for rediscount or purchase by the Federal Reserve Banks.

The Talk of Inflation

It is common observation that accompanying the progress of the Finance Corporation legislation, and expressed as a hope by some and as a fear by others, there has been much talk both here and abroad that the United States is entering upon a period of inflation. It will be worth while to give consideration to these ideas in some detail.

The word "inflation" is one of many meanings and confused usage, but definition of it must consider not only the amount of credit and currency outstanding, but the use to which it is being put. When credit is in excess over trade needs, is circulating rapidly, and is being used by the people for the purpose of bidding up prices to fictitious levels, it is proper to say that a state of inflation exists. No one would claim that this is the condition today, though the amount of Reserve Bank credit in use recently has been the largest in more than ten years.

Obviously the volume of Reserve Bank credit outstanding is not the significant factor. At a time when the demands for currency are increased abnormally by hoarding and by the larger needs of communities deprived of banking facilities, the release of an equivalent amount of Reserve Bank credit to the market inflates nothing. The withdrawal of a billion dollars in currency reduces the reserves of the member banks one billion, and the release of credit through rediscounts or open market operations increases them one billion. The total is unchanged, and the total of the loanable funds of the member banks is unchanged.

Therefore it is not conclusive to say, because the funds of the Reconstruction Finance Corporation may in last analysis be provided through expansion of Reserve Bank credit, that inflation is the consequence. The present condition will not be altered, irrespective of Federal Reserve operations, until the psychology of the people is altered and they set about returning their currency to the banks and using credit again. When that time comes there will be occasion to consider the question of inflation, but it may be said that the efforts of the government will then no longer be necessary. As the currency flows back into the banks the temporary debts created can be paid off and the credits withdrawn.

The likelihood that the financing of the Treasury's requirements, including the Corporation's obligations, will call out Reserve Bank credit is clear, since the alternative would be the sale of the securities entirely to individuals able to buy them without borrowing. However, the amount of Reserve Bank credit called into use even if the entire $2,000,000,000 contemplated for the Finance Corporation is supplied through expansion of member bank credit would be, conservatively calculated, not more than one-tenth of that sum, or $200,000,000. The reserve which member banks are required to keep with the Federal Reserve Banks against their deposits averages less than 10 per cent, and for each dollar of Reserve credit supplied an expansion of at least ten dollars in member bank deposits, and likewise in the loanable funds of the member banks, becomes possible. Thus an increase of $200,000,000 in Reserve Bank credit, which the member banks can call forth by obtaining advances upon government securities, will provide them with loanable funds of $2,000,000,000 with which they can purchase government securities. The fact that the initial transaction is a government transaction does not affect the situation. Against the deposits put to the credit of the Treasury, when a member bank subscribes to a government bond issue, no reserve is required; but as the deposits are drawn upon and disbursed by the Treasury they return to the banks as commercial deposits, against which the reserve must be kept. Of course if the disbursements should be in the form of currency which did not return to the banks, the amount of Reserve Bank credit required would be increased accordingly.

In view of the great strength of the Reserve Bank position the use of $200,000,000 of credit in a carefully administered effort to draw currency out of hiding, which will permit retirement of the credit, is obviously not a matter for alarm, but one which promises results beneficial to everyone and to all countries.

Purposes Not Inflationary

It is equally a misapprehension to assume that the purposes for which this credit will be applied are inflationary, or that in the present temper of public opinion it will be turned to such uses. The steps undertaken by the government are designed only to replace by a public source of credit the normal private sources that are dried up by the effects of fear. They are to free credit, not to create it. The action applies to an emergency only. It is no novelty in finance. In September the government of France joined with the principal Paris banks in forming a guarantee fund to enable the Banque Nationale de Credit, one of the five largest deposit banks in France, to continue normal operations. The Banque was described in the cables as having very large frozen assets, and the supporting action, taken at a midnight conference, is considered to have averted a run which would have had grave consequences. More recently the French government has provided emergency assistance for the Bank of France by making good losses sustained by the Bank on funds in London, through the depreciation of sterling. It has likewise provided financial aid to the French Line, a shipping company very important in French trade. There is no difference of principle in the two governments' actions.

The Finance Corporation is specifically forbidden to make loans "for the purpose of initiating, setting on foot or financing any enterprise not initiated" prior to the Act. It will not purchase securities, land, or goods of any kind itself, but will only operate to set free private purchasing power that is now tied up for lack of credit.

There may be fear that the temper of the people will be such as to turn the government's policies in the direction of inflation. But the evidence is that there is a strongly growing demand for economy in public expenditure and balancing of budgets, as well as a constant pressure for reduction of costs in all kinds of private business. There is no lack of harmony between this demand and the desire to release frozen and hoarded credit so that it

may circulate. President Hoover's statement that we cannot squander our way back to prosperity gives the Administration's viewpoint, and has won the approval of the country. It stands to reason that this must be so. People whose possessions are worth less and incomes reduced will not view with complacence reckless expenditures for which they will have to pay, and those whose wages have been cut will see no reason why wages of public employes should not be cut also.

It is singular that criticism of the establishment of the Finance Corporation should come from abroad. The whole world will benefit by a greater use of credit in the United States, promoting business revival. If there is objection on the philosophical ground of laissez-faire, it may be said that while a severe deflation of credit after 1929 was inevitable, the extreme liquidation since last September, the most severe ever known in a like period, has been an evil creating, as previously stated, new and greater difficulties rather than correcting old ones. Those who say credit must be liquidated "down to the bottom" are arbitrary. The bottom is a state of barter.

The Gold Reserves

Along with the verbal speculation as to inflation goes that concerning the gold standard, the sufficiency of the gold reserves of the country, and even the suggestion that the United States might go off the gold standard voluntarily.

If the United States desired to experiment with the allurements of inflation it would not be necessary to go off the gold standard to do so. In an address to the New York State Bankers Association during the past month Governor Harrison of the New York Federal Reserve Bank stated that the gold reserves of the country would permit an expansion of some $3,500,000,000 in Reserve Bank credit before reducing the reserve percentage below the legal minimum. Such expansion would increase the loanable funds of the member banks by as much as $35,000,000,000. Evidently the United States is under no credit pressure traceable to the gold standard.

It is a new concept in economics that a nation of such economic power and with such a favorable balance of payments as to constantly attract gold would benefit by voluntarily suspending gold payments, and of course it is one without responsible support. Those to whom this idea appeals as a simple cure-all for the depression would probably be greatly disappointed by the outcome. What they want is inflation; but the brake on inflation is not lack of gold, but the deflationary attitude of the people, and such a measure would more likely encourage hoarding and discourage investment than promote it.

With regard to the sufficiency of gold reserves against demands for export or increased currency withdrawals within the country, present calculations reveal a surplus above the legal minimum sufficient to provide for either (1) a loss of approximately $1,400,000,000 through export, or (2) an increase of $3,500,000,000 in domestic currency requirements. In the event of a simultaneous demand for gold and currency, the Reserve Banks after a loss of $500,000,000 in gold could still provide for $2,200,000,000 additional currency, and after a loss of $1,000,000,000 in gold for $1,000,000,000 additional currency. In addition to this, gold reserves could be further augmented somewhat by substituting Federal Reserve notes, requiring only 40 per cent gold backing, for gold certificates in circulation requiring 100 per cent gold backing. As a final emergency measure the Reserve Banks could, under the law and upon payment of certain penalties, permit their gold reserves to fall temporarily below the normally required minimum.

These figures supply impressive evidence of the strength of our reserve position and of our ability to maintain the gold standard against all eventualities short of a universal demand for cash. The hoarding of currency is not evidence of doubt of our gold position, but of distrust of banks in certain communities as a consequence of bank failures.

Cost and Price Reductions

While the government endeavors to draw currency out of hoarding and into circulation by promoting confidence, business men are working to the same end by offering bargains. There is common agreement that the automobile models designed for the 1932 market represent the best cars at the lowest price that the industry has ever offered. Finished goods of many kinds are being offered at unquestionably attractive levels, and the Fairchild retail price index for a variety of manufactured goods sold in New York department stores stood at the beginning of this year 17.2 per cent lower than one year previous. This supplies the answer to the question, what can an individual do to remedy a situation in which individuals seem powerless? Reduction of prices to levels which move goods is the historic means of overcoming depression, and is as essential as the solution of more spectacular problems. Progress in this direction has been steady.

To permit these price reductions cost reduction is necessary, which inevitably has involved the wages of labor to an increasing degree as the depression has continued. To an extent unprecedented in previous depressions wage reductions have been cooperative rather than enforced, and the freedom from wage

disputes has been one of the noteworthy characteristics of the period.

Up to September 15, one week before the United States Steel Corporation took leadership in wage reductions, there had been during 1931 2,257 cuts involving 315,229 workers reported to the Department of Labor, and 653 wage disputes. In the ensuing two months there were 1,074 reductions involving 290,082 workers, but only 107 disputes. The total number of disputes during eleven months was 760. This is an extraordinary showing when compared with the 3,411 during 1920 or the 2,385 during 1921, and demonstrates the improved mutual understanding between capital and labor that has come about over the past few years. The expected agreement by the railway unions to accept a 10 per cent wage reduction will prove an invaluable contribution in the present situation, strengthening one of the vital spots in business and finance.

In building, the other major sheltered industry, cost reduction through wage reduction is likewise making progress. It may be stated that the country generally looks upon the labor cost of building as the least deflated of all costs, but outside a few chief centers there have been many reductions, cuts in 84 cities having been listed by the Department of Labor in 1931. Now negotiations for reductions are under way virtually everywhere. In Cleveland the principal trades have accepted cuts; in Chicago the proposals are in the hands of arbitration boards; and in New York a 25 per cent reduction is sought to follow the expiration of the present agreement April 30. In view of public attention upon the subject, the mark-down of building wages will undoubtedly be interpreted as a constructive step, helpful in reviving general confidence as well as to the building situation.

1931 Corporation Earnings

Reflecting the severe decline in business volume and commodity prices, a preliminary tabulation of the annual reports of industrial corporations, numbering 315, that have been issued to date covering the year 1931 indicates a decline in aggregate net profits, less deficits, of 53 per cent from 1930 and 70 per cent from the 1929 peak, to a level that is undoubtedly the lowest since 1921. The United States Steel Corporation reported net profits, after depreciation and fixed charges but after including $19,320,000 non-operating income, of $12,967,000 for the year 1931, compared with $104,422,000 in 1930 and $197,592,000 in 1929. In the December quarter there was a net loss of $4,377,000, the first loss incurred in any quarter since the organization of the company in 1901. After payment of dividends there was a reduction in surplus of $49,237,000. General Motors Corporation has issued a preliminary statement showing net profits, after all charges and deducting extraordinary non-recurring losses, of $96,859,000, as compared with $151,099,000 in 1930. The 313 other companies engaged in a variety of different lines of manufacturing and trade reported combined net profits of approximately $218,000,000 in 1931, compared with $435,000,000 in 1930 and $653,000,000 in 1929. Of this group, 123 companies had deficits aggregating $99,000,000 last year, while in 1930 there were 64 deficits aggregating $36,000,000, which have been deducted. The tabulation includes a considerable number of companies, such as those in the cotton goods, meat packing, sugar and other industries, whose fiscal year closed before December 31, but in the latter half of the calendar year.

It is planned to present next month a tabulation based on the much larger number of reports that will be available to show the changes in earnings classified by major industrial groups.

Net operating income of the Class I railroads, with December partly estimated, was in the neighborhood of $548,000,000, which compares with $885,000,000 in 1930, $1,275,000,000 in 1929 and is the lowest since 1920.

Reduction in inventories is a feature of all corporation statements. In the case of 80 important companies whose reports are available, inventories at the end of 1931 were 20 per cent smaller in dollars than a year ago, the decline reflecting both physical shrinkage and write-downs in value to accord with market conditions. According to the Railway Age the railroads have the smallest stocks of materials in fifteen years. This is but one of innumerable indications of the deferred business which the efforts in support of credit are designed to release.

Money and Banking

The reports of member banks during January have reflected the continuance of the drastic liquidation and deflation which have been going on for the past four months. During the four weeks ended January 20 the deposits of the weekly reporting member banks showed a further shrinkage of $516,000,000, accompanied by a decline of $682,000,000 in their total loans and investments. When it is considered that deposits and loans and investments had already had a decline of $2,315,000,000 and $1,373,000,000 respectively between the end of September and the middle of December some idea may be had of the enormous difficulties against which the banking system and business in general have been contending. Under pressure of this rapid contraction of credit it is not surprising that the list of bank failures has continued distressingly long and that busi-

ness has been unable to lift itself out of the depths.

In the larger cities the high degree of liquidity enjoyed by most of the banks has enabled the majority of these institutions to take care of regular customers deserving of credit, but in many of the smaller cities and towns the situation has been extremely difficult. Numerous communities have found themselves entirely bereft of banking services through failures, and forced to do business on a cash basis or bank at a distance. In other communities where the banks are still open the losses in deposits have forced bankers almost to a standstill so far as new credits are concerned, and turned their attention largely to the collection of those which they have outstanding. Such conditions impose a tremendous hardship upon business, and lend emphasis to the contention that a solution of financial problems constitutes one of the most immediate and urgent tasks before the country.

Present Difficulties Aggravated by Forced Liquidation

It will be seen by reference to the table given below, comparing detailed figures of loans and deposits of the weekly reporting member banks over the past few years, that up until last September there had been no marked contraction in the total volume of bank credit in use and available for business. On September 30, last, the total deposits of these banks at $20,378,000,000 were practically the same as on October 2, 1929, just before the first stock market crash. While the total loans of these banks had undergone a shrinkage of $3,237,000,000, due partly to a reduction of $1,480,000,000 in loans on securities and partly to a decrease of $1,757,000,000 in "all other" loans, the credit released by this liquidation was to a large extent employed in the purchase by these banks of securities for investment, which increased by $2,515,000,000. Thus, up to the end of September 1931 the aggregate decrease in total loans and investments had been only a little over $700,000,000, while if the comparison be made up to the beginning of 1931 scarcely any decrease appears at all.

Beginning about September, however, the increase in currency outstanding, which had been going on gradually throughout the year, became more rapid and was accompanied by heavy gold exports. Between the end of September and the end of December the withdrawals of currency from the banks for hoarding purposes and for holiday trade requirements amounted to $487,000,000, while at the same time the losses in deposits due to gold exports amounted to $274,000,000. It is true that during this period there was an increase of $428,000,000 in the volume of Federal Reserve credit put in the market through the medium of increased rediscounts and bills purchased, but as this fell considerably short of replenishing the market for its lost deposits on other accounts the result was the forced contraction of credit, the extent and effects of which have already been described.

The easing of credit conditions which was hoped would follow the seasonal retirement of currency from the Christmas trade has not thus far materialized. The reduction in total outstanding circulation from the Christmas peak has been disappointingly slow, amounting up to January 27 to only $144,000,000, compared with $470,000,000 in the corresponding period of last year, and $550,000,000 two years ago. Since there is no reason to doubt that the requirements of trade itself showed the usual seasonal decline in January, the conclusion must be that the hoarding of currency increased.

Evidence of the condition resulting from these developments appears in the relatively heavy volume of member bank rediscounting at the Reserve banks. From a peak of $1,024,000,000 reached during the holidays, member bank borrowing dropped off to $818,000,000 during the first week of January, thence holding stationary at a level which, except for the last two weeks of December, is the highest since 1929. In New York City there was a reduction in borrowing to negligible proportions, but for the System, excluding New York, the volume of rediscounting increased during January to the highest levels since November 1929.

Weekly Reporting Member Banks
(Millions of Dollars)

	Oct. 2, 1929	Jan. 22, 1930	June 25, 1930	Jan. 21, 1931	June 24, 1931	Sept. 30, 1931	Jan. 13, 1932
Total Loans and Investments	22,829	22,237	23,140	22,603	22,343	22,107	20,287
Total Loans	17,428	16,688	17,059	15,839	14,540	14,191	13,031
Loans on Securities	7,826	7,714	8,487	7.425	6,703	6,346	5,660
All Other	9,602	8,974	8,572	8,414	7,837	7,845	7,371
Investments	5,401	5,549	6,081	6,764	7,803	7,916	7,256
Total Deposits	20,347	20,086	21,045	20,880	20,764	20,378	17,751
Net Demand	13,295	13,135	13,560	13,689	13,286	13,227	11,643
Time	6,825	6,915	7,273	7,090	7,169	6,775	5,843
Government	227	36	212	101	309	376	265

Reduction in Reserve Bank Buying Rates

During the week of January 16 the Federal Reserve Banks made three cuts in their buying rates for acceptances, reducing these rates to 2¾ per cent for maturities up to 45 days and to 3 per cent for maturities from 46 to 120 days. These reductions were apparently a move to bring Federal Reserve rates more in line with the market, since at the old rates the Federal had been unable to attract bills, with the result that its portfolio was running off rapidly. An effect of the lower official rates was a drop in the open market rate from 3 to 2¾ per cent. At the new bid rates, however, the Federal Reserve still failed to obtain bills, and in the two weeks ended the 27th its portfolio showed a further reduction of $52,000,000 to $162,000,000, the lowest since September, and a decline of over $500,000,000 since October when the withdrawal of foreign funds from the bill market forced a large volume of acceptances into the Reserve bank.

Other changes in rates included a slight shading of stock market time money rates, and a decline in call money from 3½ per cent to 2½ per cent. Open market commercial paper was unchanged at 3¾-4 per cent for best names. The prevalence of rates as low as this in the principal short-term money markets in a time of general stringency is indicative of the premium which lenders are willing to pay for unquestioned liquidity.

The reduction of Reserve Bank buying rates, regarded as a forerunner to a reduction in the discount rate, appears to have caused some revival of fears in Europe that this country was embarking on a program of inflation. Approximately $77,000,000 in gold was exported from the United States to Europe during the month, of which $63,000,000 went to France, and $8,248,000 to Belgium. Of the shipments to France, $44,000,000 came out of stocks already under earmark in this country, hence did not affect our reserve position. According to press reports, it is the intention of the Bank of France to repatriate the balance of the $125,000,000 which it has held here under earmark. Gold imports for the month totaled $30,000,000 in all, including $10,067,000 from Japan, $8,140,000 from Argentina, $2,941,000 from Colombia $3,871,000 from Canada, and $3,223,000 from India, thus making the net change in total monetary stocks a decrease of $37,000,000.

The Bond Market

The bond market during the past month has made a more satisfactory showing. Prices of corporate bonds advanced from the middle of December to the middle of January, and in the case of the lower-rated issues particularly recovered nearly to the mid-November levels. In the last two weeks they have yielded ground, but only in slight measure. Foreign bonds have followed a similar course.

In United States government bonds the action has been the reverse. The decline continued until nearly the middle of the month, when two of the long-term Treasury issues sold to yield more than 4¾ per cent, and the 3s that were sold at par last September dropped to 82 3/32. Thereafter the market was firmer. The action of state and municipal bonds has been similar. This is the first instance during the depression of government bonds declining while others advanced.

When the business depression began to influence the bond market its effects were felt first in foreign issues and in the lower-rated domestic bonds. Early in 1930 both private investors and banks began to shift funds from those groups into the higher-rated corporate issues and into governments, a corresponding spread in prices developing. In the early part of 1931 governments and the very highest grade domestic bonds still enjoyed marked preference, although by Summer liquidation in these also began to appear, the decline thereafter embracing all groups.

To this trend the advance in corporate bonds during January while governments were declining affords an interesting contrast. As there has been no general improvement in business to cause the price recovery in the lower grade issues the evidence is that the December decline had been overdone; that it forced some issues down not merely to receivership prices but to less than their value in receivership; and that the bargain levels themselves attracted sufficient buying to turn the market. The buying has not come from the banks, but from other quarters, since in the four weeks ending January 13, covering the period of the rally, the investments in other than U. S. Government securities of the reporting member banks declined $155,000,000.

In the case of governmental obligations of all kinds the market influences have been very different. The cause of apprehension in the Federal bond market has been the prospect of a continuing heavy increase in Treasury requirements for funds, while with respect to local government issues uncertainty as to the fiscal position and policy of many communities has been sufficiently marked to cause general unsettlement. The rally after the decline was a natural one, brought on at the moment by the expectation of lower money rates created by the reduction of the New York Federal Reserve Bank's bill buying rate; and also by actions and statements in Washington, and in states and municipalities, indicating intention to reduce expenses and balance budgets.

The railroad bonds have made relatively the best showing of any in the corporate group,

reflecting expectation of a wage cut and the organization of the Reconstruction Finance Corporation. Another event of importance was the adoption in New York State of a law providing that failure to earn its fixed charges one and one-half times in 1931 should not disqualify for savings bank investment bonds of a railway now eligible, if not in default. This is a temporary alteration, suitable to the emergency, in the law requiring that charges shall be covered by the margin stated in five out of six years, including the immediately preceding year.

It is fortunate that the total of bonds maturing in 1932 is a small one. In the case of foreign issues, including serial maturities, the amount is only $34,000,000; of the railroads, including short-term notes but excluding equipment trust obligations and other loans, $130,000,000; of industrial and finance corporations $281,000,000; all these being very much below last year. Public utility maturities, however, are larger, $507,000,000 against $254,000,000. The capacity of the bond market to take care of these maturities and to supply new capital for industrial revival will continue to depend largely upon credit conditions generally and upon the state of mind of the individual investor, which have been the controlling factors for the past several months.

Reduction of Governmental Costs

The outstanding success accorded the offering of $100,000,000 corporate stock by the City of New York demonstrates the prompt effect upon public credit of a policy of adjusting governmental expenditures to revenues so as to prevent budget deficits and increases in public debt. By its stand to curtail expenditures for operations and postponing all capital outlays not absolutely necessary, New York City has vindicated the high rating of its obligations, and shown the only sure way out of the widespread difficulties existing in national, state and municipal finance.

Cost of government in New York City, as elsewhere, had risen rapidly during recent years as a result of multiplying the number of bureaus and office-holders, raising salaries, etc., together with an extensive program of public improvements causing a large increase in its bonded debt, interest and sinking fund charges. Between 1922 and 1932 the budget, exclusive of capital outlays, had been increased from approximately $351,000,000 to $631,000,000 and net funded debt from $1,067,000,000 to $1,737,000,000.

So long as realty values were rising this mounting volume of expenditure and debt was regarded with more or less complacency. During the past two years, however, the picture has undergone a decided change. Real estate values have had a large decline, indicating the probability that assessed valuations for tax purposes will have to be reduced, thus forecasting a decline in the city's revenues from the general property tax. Some lag in the collection of taxes has occurred, and added expenses have been assumed for the relief of the unemployed. These developments in the face of a contemplated building program that would cost in excess of $1,500,000,000 over the next decade, coupled with the effects of the marked contraction of bank credit, have made investors wary and caused so severe a decline in the price of the city's outstanding securities as to practically close the market to the offering of additional issues. Accordingly at the beginning of 1932 the city found that it would not be in a position to meet substantial maturities shortly falling due, or even payrolls and other current bills.

In this emergency representative New York bankers were invited to meet with the city officials in an effort to work out a financial program to provide the necessary funds. Inasmuch as the position of bankers in such negotiations is frequently not understood by the public it is well to emphasize the statement often repeated, that underwriting bankers do not engage themselves to buy hundreds of millions of bonds as investments of their own institutions. They make such purchases as dealers, in the expectation of selling to the public. Experience enables them to judge the bond market from time to time and have an informed opinion upon the terms and assurances that must be given to secure the desired distribution for a proposed issue. In this instance the bankers consulted were of the opinion that the city authorities should definitely reduce their program of expenditures and debt-creation, and gave advice accordingly, without, however, attempting to specify what particular items in the budget should be readjusted, this question being regarded as one for the administration.

The city government faced the issue and adopted a comprehensive resolution on financial policy to meet the changed economic conditions, declaring, among other things, that:

> The City Administration shall forthwith undertake measures to curtail and postpone its plans and undertakings; shall seek in every way to reduce the cost of its present activities, and shall endeavor to limit new projects to those which are self-sustaining in order that the City may more effectively employ its resources in serving the vital needs of the people; and
>
> That studies will be promptly undertaken with the purpose of developing new sources of revenue and of determining what present activities of the City may be put on a totally or partially self-supporting basis; further that each department head is hereby directed to submit his plan in accordance with the terms of this resolution and as promptly as possible to make a report to the Mayor on such suggestions or plans.

As a first step in carrying out this program, the Board of Estimate postponed indefinitely

the consideration of new projects totaling $110,115,121, including the Delaware water supply extension calling for $78,859,000, various general items amounting to $26,726,000 and Board of Education proposals of $3,708,-000. These items, affecting virtually every city department, were placed on a newly created "suspense calendar" from which they are to be transferred to the regular calendar only when the city's improved financial condition warrants such action.

The negotiations with the bankers resulted in an agreement on the part of the latter to buy at once $100,000,000 of the city's corporate stock 6 per cent notes, running 3, 4 and 5 years and to provide a revolving credit fund of $151,-000,000 to take care of current needs between tax-collections. The bankers paid par for the $100,000,000 notes and immediately offered them to the public at the same price, volunteering their services without profit in order that there might be no question as to their motives in giving the advice which had been adopted. The flotation was a pronounced success and market prices of outstanding New York City issues also were improved.

Importance of the Market for Government Issues

Not only is the balancing of budgets imperative if the credit of the various borrowing branches of our government is to be sustained, but the prices of government issues are of great influence upon the general securities market and thus affect the business situation. These public issues, particularly those of the Federal Government, states and large municipalities, have been the backbone of the bond market in the past, and so long as demand is light and prices are sagging in this division of the market there cannot be much life or vigor in other classes of bonds. An improved market in governments is a necessary preliminary to breaking the deadlock in the new capital market and reopening the channels supplying funds for all kinds of long term corporate financing, without which the making of capital expenditures is at a standstill.

Growth of Expenditures

During the past twenty years there has been a six-fold increase in governmental expenditures and in public debt. Gross indebtedness of Federal, state and local governments is now around $32,000,000,000 whereas in 1912 it was but $4,850,000,000. Of this amount, the United States Government accounts for $16,-000,000,000, the remainder being state and local borrowings, the increase in which between 1922 and 1932 has entirely offset the $10,000,000,000 reduction that was made in Federal debt. Total expenditures of governments increased from $2,040,000,000 in 1912 to $6,700,000,000 in 1922 and $12,000,000,000 last year.

In analyzing the distribution of municipal expenditures and the groups in which the greatest increases have occurred during recent years, the annual compilation of financial transactions of all municipalities in New York State is of interest. The following table shows the combined expenditures in 1920 and 1930 of the 1,573 cities, towns, villages and counties, exclusive of the three largest cities, New York, Buffalo and Rochester, and the percentage change during the period:

Operating Expenses and Interest of New York State Municipalities (a)

(In thousands of dollars)

	Expenditures 1920	Expenditures 1930	Per Cent Change
General Government	$ 15,047	$ 31,760	+111.1
Protection of Persons and Property	10,889	28,978	+166.1
Health and Sanitation	7,307	17,758	+143.0
Highways	19,701	42,116	+113.8
Charities and Corrections	9,627	21,776	+126.2
Education	38,274	98,241	+156.7
Recreation	1,008	5,299	+425.7
Public Utilities	7,252	14,165	+ 95.3
Interest	6,935	31,154	+349.2
All Other	1,165	3,149	+170.3
Grand Total	$117,202	$294,399	+151.2

(a) Exclusive of New York, Buffalo and Rochester.

The items listed in the table are of a character to temper hasty criticism of increasing municipal expenditure. The increasing sums devoted to such purposes as education, health and sanitation, and highway construction represent a trend which is bound to continue and which the public would not wish to reverse. At the same time it must be realized that communities can over-reach themselves even in these matters. Considering the fact that the tabulation covers only operating expenses and interest, the 151 per cent increase shown in municipal government costs during the space of ten years, when the population of the State increased but 21 per cent, raises a large question as to its justification.

Even during such prosperous years as 1928 and 1929 the aggregate tax bill over the country was a heavy drain upon business and personal incomes, but the shrinkage in incomes during the depression has made the tax burden almost unbearable. Public officials have apparently been the last to realize the changed conditions. In numerous cities the property owners have been unable or unwilling to pay their tax assessments and have held meetings to protest against the high level of government costs or to call "taxpayers' strikes." As tax collections fell in arrears, the city treasuries have become short of funds for meeting their payrolls, debt service and payments for building, as well as special expenditures authorized for unemployment relief. The neces-

sity for relief expenditures emphasizes the importance of retrenchment in less urgent quarters, the responsibility of allocation resting upon the city authorities.

The old saying that what is everybody's business is nobody's business aptly applies to public finance. If times are good and property values are rising, the average citizen does not complain against the constant increase in his tax assessments but is willing to leave the whole question of government finance in the hands of the officials. Millions of people in this country having the right of citizenship are not interested enough to cast a ballot for elections or to decide important issues.

The business depression has awakened the people to the unpleasant fact that the combined expenses of operating their various governments constitute one of the heaviest liabilities facing them today. The imperative need for economy is now coming to be more generally recognized and a number of other cities and states have also made outstanding progress in working out programs to straighten out their financial affairs.

In Detroit, for example, a committee composed of representatives of important civic organizations has been operating during the past two years with the city government in carrying out a comprehensive plan for operating economies and postponement of capital expenditures, which has reduced expenditures for all purposes from $175,000,000 in the fiscal year 1930-31 to $116,000,000 in the fiscal year 1931-32, and provided for amortizing its unwieldy short-term debt over a five-year period.

The State of North Carolina, which during the several years prior to 1929 had been embarked on an extensive and costly program of public improvement, particularly road building and education, furnishes another constructive example of promptness in adjusting public expenditures in line with present economic conditions. By means of a rigorous program of retrenchment, including reduction of salaries, reorganization of government departments, control of borrowing by counties and municipalities and the tapping of certain new sources of revenue, $9,750,000 in state debt was paid off and a lowering of the property tax was made possible. The State of Tennessee convened a special session of its Legislature at which a number of new or increased taxes were imposed and administrative expenses reduced so as to bring the budget into balance during the current year. The State of New Jersey at a recent session of its Legislature has cancelled a large total of appropriations that had been authorized but not yet used, so that instead of a deficit of between $3,000,000 and $4,000,000 in the State Treasury for the year ending June 30 next, there will be only about $731,000.

Governor Moore of New Jersey in his inaugural address in January reflected the trend of public opinion when he said:

> Unless unnecessary expenses are eliminated and the burden of taxation is relieved and reduced, return to prosperity will be immeasurably delayed . . . The only way to reduce expense is to apply ourselves to the problem sincerely and earnestly . . . Budgets must be cut to the bone. Not only this must be accomplished, but it seems to me vital that every government service, the execution or completion of which is not essential at this time, should be postponed.

Revising System of Tax Collections

One of the most serious weaknesses in the present system of municipal finance is the fact that collections from taxes are received only once or twice a year, whereas expenditures run at a fairly constant rate. This causes the city treasury to have a surplus of cash during part of each year but to have a shortage of cash and be required to borrow during the remaining, and usually much larger part of each year. Of 168 leading American cities whose reports are regularly tabulated in the National Municipal Review, 107 cities have but one tax collection per year, 56 collect semi-annually and 5 collect one-third of the tax every four months.

The annual budget of appropriations for the different departments is usually decided upon shortly before the beginning of each fiscal year, but it is not until the end of that year that the receipts are all collected and the total is known.

Although this method is traditional and is in almost universal use, there appear to be a number of fundamental objections to the practice, viz:

1. If the city spends money before it is received, the interest charge on borrowings becomes an added expense in the budget.
2. When the city has large balances in the banks, the interest received on deposits is less than that being paid on its outstanding bonds.
3. The annual appropriations are made long before the city can tell accurately what the actual receipts will be.
4. There is no provision for revising the program of expenditures during the year so as to conform with changing revenues.
5. When, as frequently happens, a department spends all of its annual allotment before the end of the year, a deficiency appropriation becomes necessary.
6. From the standpoint of the property owner, the payment of taxes in more frequent instalments would reduce the burden at any particular time of the year.
7. In the matter of administration, the present system causes most of the work to be concentrated in a short period, whereas if it were spread out evenly it could be handled much more economically.

There is no particular reason why people should make their payments for cost of government only once a year, or even twice, except that the custom has grown up over a long period of time when the amount of taxes paid was relatively insignificant compared with the amount today. The Federal Government has

taken an important step forward by making income taxes payable quarterly, and there seems to be no good reason why local governments should not do likewise.

An alternate proposal that has been advanced is to "stagger" the receipts by means of a zoning arrangement, whereby the property owners in different zones would make their payments at different times, thus giving the city a more even flow of revenue.

The adoption of either system, more frequent instalments or zoning, would obviate the unsatisfactory results of alternate borrowings and surpluses of cash. More important still, it would make possible a constant check on actual revenues and permit a quarterly or even monthly revision of the program of expenditures to correspond. Such a system would reduce government operations more nearly to a cash basis in contrast with operating largely on credit, and would undoubtedly result in more careful spending. The change should be welcomed by taxpayers, and it would distribute the administrative work of billing and collecting taxes, making assessments and reviewing valuations. If coupled with a provision to control the departmental expenditures by apportioning the annual budget into months or quarters, the benefit to municipal finance and municipal credit should be great.

United States Treasury Finances

The Congress of the United States is now in the midst of preparing its program for bringing the national government budget into balance. Its revenues are mainly dependent upon corporate and personal incomes and the decline during the past two years has been much more severe than in the case of local governments, which derive their revenue chiefly from property taxes. Postponement of payments of intergovernmental debts will eliminate $270,000,000 in revenues that will have to be made up from other sources during the current fiscal year.

A schedule of materially increased taxes has been proposed and, except for possible changes in minor details, should be adopted promptly in order to remove the prevailing uncertainty as to what the new tax rates will be and how much additional Government borrowing will be required. The Treasury has estimated a deficit of $2,122,000,000 for the fiscal year ending June 30, 1932, but this does not take into account the $500,000,000 that has since been appropriated to the Reconstruction Finance Corporation, $125,000,000 to the Federal Land Banks and other relief measures that have been or are expected to be passed. From July 1, 1931, through January 26, 1932, the excess of expenditures over receipts amounted to $1,481,000,000. It is planned, however, to bring the budget into balance and arrest borrowing by June 30, 1933, the end of the following fiscal year.

To bring about a balance by that time will be no easy task. It will demand not only economy in the usual sense and the avoidance of a multitude of new projects that are always being brought forward calling for the use of public funds, but a real deflation in the operating cost of government. The drastic decline that has taken place in the income of the American people from agriculture, from manufacturing and trade, from wages, interest and dividends, demands a large cut in the burden of government costs and debts, and neither public credit nor public confidence can be completely restored until this is done.

Total governmental expenditures, exclusive of debt retirement, amounted to approximately $3,652,000,000 in the fiscal year 1931. They are estimated at $3,950,000,000 in 1932 and $3,500,000,000 in 1933, although these figures do not include the special appropriations for relief work. While the program of economy has effected substantial reductions in the estimated expenditures for 1933 as compared with 1932, the expenses of a number of departments are still very high as compared with those of say ten years previous, as may be seen from the following partial list compiled from the reports of the Secretary of the Treasury. In 1923, total expenditures were $3,245,000,000 and in 1913 only $725,000,000.

United States Governmental Expenditures
(In millions of dollars)

Department	1923	1932	1933
Legislative Establishment	$ 14	$ 32	$ 23
Veterans' Administration	462	784	830
Department of Agriculture	129	334	216
Department of Commerce	22	55	48
Department of Justice	24	54	53
Department of Labor	7	14	15
Navy Department	333	379	375
Treasury Department	145	313	280
War Department	393	484	430
Postal deficiency	33	195	155
Panama Canal	4	11	13
Adjusted Service Certificate Fund	—	200	150

Because of the transfer of certain functions from one department to another that are made from time to time, the figures for 1923 and 1933 are not strictly comparable in all cases, but this fact does not materially alter the picture of expansion and spending during a decade several years removed from the war period. The increase in "ordinary expenditures" more than offset the saving of $450,000,000 in interest on the public debt, achieved by the retirement of $10,000,000,000 in bonds and by strengthening the credit standing of government obligations so that refunding could be done at constantly lower rates. Unless the benefits derived from the succession of annual surpluses from 1920 to 1930 applied to debt

retirement are to be wholly wasted, a courageous tax program is now demanded, together with a cutting of expenditures much more drastic than anything that has been adopted up to the present time.

Reparations and Debts

The conference upon reparations called to meet at Lausanne last month was postponed indefinitely, for the reason that an agreement was unlikely to be reached, in which case it might be better that no meeting had been held. When the conference was called by Premier MacDonald, of Great Britain, he planned that it should consider both reparations and intergovernmental debts and that the United States should participate, but this country has uniformly declined to admit that the two subjects are related, and the action of both houses of Congress in passing resolutions against any further revision of the debt settlements has determined the position of this Government at least for the present.

Although the European debtors do not like the attitude of the United States Government it would be better for the interests involved if they would accept the situation as it is and endeavor to arrive at a new agreement with Germany upon the basis of Germany's capacity to pay, rather than upon the basis of what they fear they may have to pay to the United States. They will gain nothing by making impossible demands upon Germany, whatever may be the outcome of their claims on the United States. President Hoover, by his message to Congress recommending the re-establishment of the Foreign Debt Commission, has shown that he is favorable to a re-examination of the debts and undoubtedly he has much public sentiment to support him. The attitude of Congress may change, and anyway the reparations question is the immediate issue and should be settled on its own state of facts.

The problem of reparations and debts seems to defy solution chiefly because it is involved in the domestic politics of the countries concerned, and the political authorities are unwilling to assume responsibility for making the concessions that are necessary to an agreement. The economic realities which finally determine the practicability of any plan of settlement receive little attention.

The Dawes Plan

The first deadlock on reparations was broken by the establishment of the Dawes Committee, whose report in the light of today is seen to have been impartial and as well conceived and safeguarded as could be expected of a plan made at that time. Germany was protected by the provision suspending payments when they could not be made without imperilling the currency, and the creditors were given the benefit of a provision under which payments might be increased pursuant to a prosperity test. Mr. S. Parker Gilbert, who supervised the transfer of payments throughout the life of the Dawes Plan, has emphasized the experimental character of the Plan. In his report for 1927 Mr. Gilbert said:

> The Plan of the Experts sought above all to reduce the problem of reparations to a practical and businesslike programme under which, instead of unsettling and retarding the reconstruction of Germany and of Europe, reparation payments might become a positive influence for stability and economic recovery. The Plan aimed to reestablish Germany as a going concern and to provide a fair trial, under conditions of security and mutual confidence, of the ability of Germany to pay and of the capacity of the creditor Powers to receive reparations. Experience, and experience alone, would prove what was practicable.

The Plan was necessarily experimental, for no undertaking on the part of one country to pay money in sums of such magnitude to foreign countries ever had been known. The Dawes Committee recognized the inherent difficulties, hence the transfer provision, which if in force today would bar any attempt to make reparation payments in the present state of the Reichsbank's reserves. The transfer provision was abandoned in the Young Plan because the successful operation of the Dawes Plan in years of prosperity, together with the reduction of the annuities and the provision for conditional payments in emergency years, were thought to render it unnecessary. It is evident now that the principle embodied in the transfer provision is sound and whether in the Plan or not must be observed in order that any scheme of cash payments may be carried out.

The Basle Committee

The Young Plan provides that in the event that the full payments should threaten the stability of the currency Germany may make representations to this effect to the Bank for International Settlements, in which case an Advisory Committee of Experts shall be appointed to examine and report upon the necessity for a temporary suspension of the "conditional" payments. Germany having made such representations in November last such a Committee was created, consisting of eleven persons of high repute and position, from as many countries, and it submitted a unanimous report in December. It is noteworthy that the members from Belgium, France, Great Britain and Italy, countries interested in reparations, signed with the others. The report reviews economic conditions in Germany in considerable detail, finding that owing to the depression one-third of the industrial life of the country had stopped; that the Reichsbank reserve which had stood at 2,685,000,000 reichsmarks at the end of 1930 had declined to 1,-161,000,000 on December 15, 1931; that not-

withstanding drastic reductions in public expenditures a critical situation exists in the public finances and that taxation is so heavy as to leave "no margin for further increase;" that the scarcity of capital is such that manufacturing companies of good credit are obliged to pay 12 per cent interest upon loans, etc. Coming to the particular point upon which it was charged to report, the finding is that Germany would be justified in declaring, in accordance with her rights under the Young Plan, that she "will not be able to transfer the conditional part of her payments in the year beginning July 1, 1932."

The Committee went beyond the specific finding for which it was created, and stated that it "would not feel that it had fully accomplished its task if it did not draw the attention of the Governments to the unprecedented gravity of the crisis," "the magnitude of which undoubtedly exceeds the relatively short depression against which the Young Plan provided measures of safeguard." This is virtually finding that the emergency provision of the Young Plan is inadequate to meet the present situation.

The report adds that the Young Plan with its rising series of annuities contemplated a steady expansion of world trade, in which case the annuities payable by Germany would become a factor of diminishing importance, but that in fact "the opposite has been the case." In short, the language of the report is very grave, not only as to conditions in Germany but as to the repercussions which had been felt and might yet be felt, upon the rest of Europe and throughout the world, concluding with the following paragraph:

> We appeal to the Governments on whom the responsibility for action rests to permit no delay in coming to decisions which will bring an amelioration of the grave crisis which weighs so heavily upon all alike.

Premier Bruening's Statement

On the strength of this Advisory Report Premier Bruening of Germany gave out a statement to the effect that in the Lausanne conference he would take the position that Germany would not be in condition to make any reparation payments for a very long time and that the Young Plan, which requires the continuance of the "unconditional" payments, must be condemned as impossible of fulfillment and therefore no longer in effect.

In view of the Advisory Committee's report it is probable that the French authorities would have been willing to go the full length of the Young Plan and perhaps make some temporary arrangement regarding the unconditional payments, but the proposal to end all reparation obligations caused them to make an uncompromising protest. They condemned it as forestalling action by the Lausanne Conference, which therefore they said might as well not be held. They also firmly assumed the position that an agreement between nations cannot be disposed of by unilateral action, but could be altered or nullified only by the concurrent action of both or all of the parties who made it. This, it may be noted, is a similar position to that held in Washington.

There is a question as to whether Premier Bruening intended his statement to be as peremptory as it seemed to be in print. An explanation has been made that he was not intending to forestall the Conference but only to summarize the argument which he would make there. It is quite certain that he did not want to prevent the Conference being held or a discussion of reparations, for he is now urging that a new date for the meeting be named. In view, however, of the political situation in Germany it is doubtful that he will be able to recede from the position which he has announced and remain in power. On the other hand it seems equally improbable that the Government of France will agree to an unconditional termination of all reparation payments.

The Threatened Impasse

France has indicated that she will not be ready to make a new agreement with Germany until she knows what the United States is ready to do about reducing its claim upon her, and others of our debtors, although not all, are understood to hold a similar position. This is placing upon the United States a responsibility regarding reparations which this Government has repeatedly declined to accept, thus there is presented the danger of complete inaction with resulting defaults upon all of these obligations. If no new agreement is reached it is certain that Germany will default upon reparations, for according to the Advisory Report she could not do otherwise if she wanted to, and apparently public opinion has reached the point of welcoming a breakdown of the Young Plan. If her creditors refuse to negotiate with her because the United States refuses to negotiate with them, Germany will claim that the blame does not belong to her.

The resolutions of Congress, together with speeches made while they were pending, indicate that that body contemplates the probability of defaults upon the debts to this country and prefers to have the chapter upon these loans closed in this manner rather than by further negotiations and readjustments.

It may be that this is the only way out of the situation which has developed, but surely this is a deplorable conclusion and one which should not be readily accepted. It will mean that the most enlightened nations of the time, in the midst of unparalleled distress among their people, resulting from the disorganiza-

tion of finance and industry, are not enlightened enough to compose their differences by the methods of reason and compromise, in order that they may work together for the restoration of a common prosperity.

It is a serious matter for the leading nations of the world either to show disregard for their solemn obligations or to maintain an uncompromising attitude which may provoke or compel a deliberate policy of default. It is in the interest of society that obligations entered upon between nations shall be honored in the highest sense of the word, by both debtor and creditor. There should be a scrupulous desire upon both sides to insist upon only what is right and economically practicable; and a willingness on all sides to make allowance for different viewpoints, in order that agreement may be reached. The question is, how much more desirable is amicable agreement than lasting deadlock?

The assumption prevails that there will be no war to enforce collection of either reparations or debts. Probably this is so. War would be the ruin of Europe, and the report of the Advisory Committee shows that it would not collect reparations from Germany. France is not seeking territory and so far as the United States is concerned there is no thought of attempting collection by force.

Even so, what would be the influence of a permanent state of deadlock over these claims upon all international relations. There is greater need for cooperation among the nations for the support of credit, the re-establishment of a common standard of value, the revival of industry and trade, than ever has been known before. Defaults of themselves would not accomplish settlements or furnish a basis for cooperation, which requires mutual confidence and recognition of common interests. Controversy would continue, and antagonisms and resentments probably would find expression in more legislation harmful to trade.

The situation in Germany calls urgently for a settlement. Industrially and in trade Germany is the most important country on the continent of Europe, and whatever happens to her must seriously affect the prosperity of all Europe. Germany is being strangled by the scarcity of capital and credit, due to hoarding of currency, withdrawal of foreign funds and flight of German capital, all natural results of the reparations dispute. The country can neither pay reparations nor prosper without paying them unless it can obtain capital to operate its industries.

Cause of the Breakdown

Finally it is important that instead of insisting upon the performance in full of certain obligations entered upon without regard on either side to the fundamental economic factors involved, careful consideration shall be given to these factors now, before closing the door to practical settlements.

It is a question whether the world's inflated and unbalanced economic structure in 1923-24 was inherently weak and bound to collapse, or whether the reparations and debt settlements have played the principal part in upsetting the world equilibrium. It is certain that the political authorities have disregarded the principles which the Dawes Committee laid down as necessarily governing the collection of reparations and which of course govern all international payments as well. The fundamental principle was that Germany could pay only by an excess of exports over imports; in other words, that payments of such magnitude across international boundaries must be made in goods or services, because they tend to increase the international balances required to be paid in gold, the effect of which may be to compel a disastrous contraction of credit in a debtor country or force it off the gold basis. Either result would be certain to have disastrous results in other countries and also certain to soon put an end to the payments in question.

The authorities have ignored the confessedly experimental character of the Dawes Plan, which dealt with a problem for which there was no precedent, and which Mr. Gilbert has said "aimed to establish Germany as a going concern and provide a fair trial of the ability of Germany to pay and of these creditor Powers to receive reparations." Mr. Gilbert added the obvious comment, "Experience and experience alone could prove what was practicable."

The problem of reparations and international government debts has been an obscure and doubtful one from the beginning. Various opinions have prevailed about it, but the overwhelming mass of opinion in the creditor countries has been simply that they ought to be paid, with little serious consideration of the difficulties against which the Dawes Committee had given warning.

In the September, 1927, number of this Letter, comment was made upon the observations of several European bankers and economists, who held that the Federal Reserve authorities were unwisely restricting the expansion of credit and preventing a rise of prices which naturally should result from our increasing stocks of gold. The European view was that the Federal Reserve system should deliberately favor a rise of commodity prices which would eventually turn the exchanges against this country and cause a return movement of gold to Europe. Our comments touched upon the gold accumulations and the balance of payments, and are reproduced in part herewith:

"The World Equilibrium"

We are not questioning the importance of the world equilibrium, which undoubtedly has been disturbed by the events of the last twelve years. The needs of Europe for current credit cannot be adequately supplied from the United States and if the balance of payments running to this country actually threatens to prevent Europe from acquiring a normal increase of banking reserves, the situation is serious and not at all to the advantage of this country. It may be doubted that such is the case, and, any way, inflation does not appear to be a necessary remedy. The international accounts are not fixed and unchanging but have numerous items which are changing constantly, either under the influence of governmental policies or the natural influence of economic conditions. Arguments in regard to governmental policies on the tariff and foreign debt settlements have been urged on this account, but it has not been made clear that the balance of payments needs to be taken into account in dealing with these subjects. Thus far, the opinion has prevailed that our international transactions are of such magnitude and variety that they will adapt themselves to conditions, and that the equilibrium will be maintained by the play of natural economic forces.

It may be that this view is erroneous, but as yet it has not been conclusively disproved. There is so much obscurity about the international accounts, and so many difficulties are encountered in attempting to make up a statement of them that opinions may easily differ over the calculations.

The foregoing does not express a very definite opinion, but recognizes the uncertainties of the situation. Up to that time there was little evidence that the world equilibrium was being disturbed, and that this was so must be credited mainly to the foreign loans which were being made by this country. These loans checked the tendency of gold to accumulate in this country and distributed purchasing-power and debt-paying power to other countries in the form of credit. It was not until this country ceased to lend abroad freely that the calamitous drain of gold to this country began and the world crisis developed.

The Crucial Problem of Transfer

In all the popular discussion of reparations and debts almost no attention is given the problem of transfer or conversion from one currency to another. Over and over there is insistence that Germany should pay reparations and the allied Governments should repay the money they borrowed of the United States according to agreements, without recognition of the problem which the Dawes Committee foresaw in making the provision limiting drafts on Germany's gold reserves. This is something apparently not taken into account in most of the demands that the reparations and debt agreements be carried out to the full. The view prompting these demands is perhaps accurately reflected in the comment that Germany could pay reparations by reducing the consumption of beer to the extent of one glass daily per person. If that quantity of beer would equal in value the reparations payments and the creditor powers would accept it as covering the payments there would be some point in the comment, but the creditor powers want gold instead of beer.

The precise extent to which reparations and inter-governmental debt payments are responsible for the great depression and fall of prices from which the world is suffering cannot be fixed, but economists were apprehensive of the effects of these payments from the first. They pointed out that before the war the United States had a substantial favorable balance in trade, but was a debtor country in finance, and that if as a result of the war it quickly changed to a creditor position in finance, so that including all foreign relations it would have a continuing favorable balance of payments, an unstable situation would be created. The United States would be continually drawing on the gold reserves of other countries, except as the situation was corrected by foreign loans, and there could be no certainty that foreign loans in the required amount would be made. This prediction has been realized and with the result apprehended.

The London Economist in a recent editorial upon the subject says: "We say without hesitation that whatever the countries chiefly concerned might be disposed to do they dare not enter into any international scheme for the stabilization of money so long as these great payments are in danger of again becoming a disturbing factor in the world's financial system."

This problem of transfer is not a fanciful consideration. It is the fundamental question in reparation and debt payments, and it is high time that statesmen gave it the attention it deserves. International trade and financial transactions must balance out within comparatively narrow limits or there can be no world monetary system such as the gold standard has furnished, no stabilization of the exchanges, no fixed relations between the currencies of different countries, or common basis for commodity prices. These are matters of vast importance in world trade and in the welfare of all populations. The world has enjoyed the benefits of the universal gold standard so unconsciously that it has scarcely known whence they were derived or the conditions that are essential to the operation of the system.